RICHARD RUSSELL'S **DOW THEORY LETTERS, INC.**

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May 21, DJIA 835.90; PTI 1394; A-D Ratio –24.83
May 28, DJIA 819.54; PTI 1366; A-D Ratio –25.70

THE PICTURE: The position of the Federal Reserve Board regarding bankruptcies and financial emergencies is now fairly clear (as per the Drysdale affair). The Fed will do whatever it has to—to hold the US banking system together. But the Fed will not bail out collapsing corporations such as Braniff, International Harvester, Wickes, etc. Meanwhile, as the WSJ (May 24) put it, "A bankruptcy epidemic is sweeping American business, and there is no let up in sight." Bankruptcies are now running at the rate of 74,000 per year, highest in history.

Why? What's happening? For one thing, manufacturers are finding that (with sliding inflation rates) there is tremendous consumer resistance to price increases. Second, interest rates and the cost of holding inventory remains high. Finally, labor continues to ask for more, and expenses in general continue to rise. The result: tumbling profits as the nation's corporations are caught in a vicious squeeze. The outcome: layoffs, factory closings, and pressure on labor to back off or face a loss of jobs.

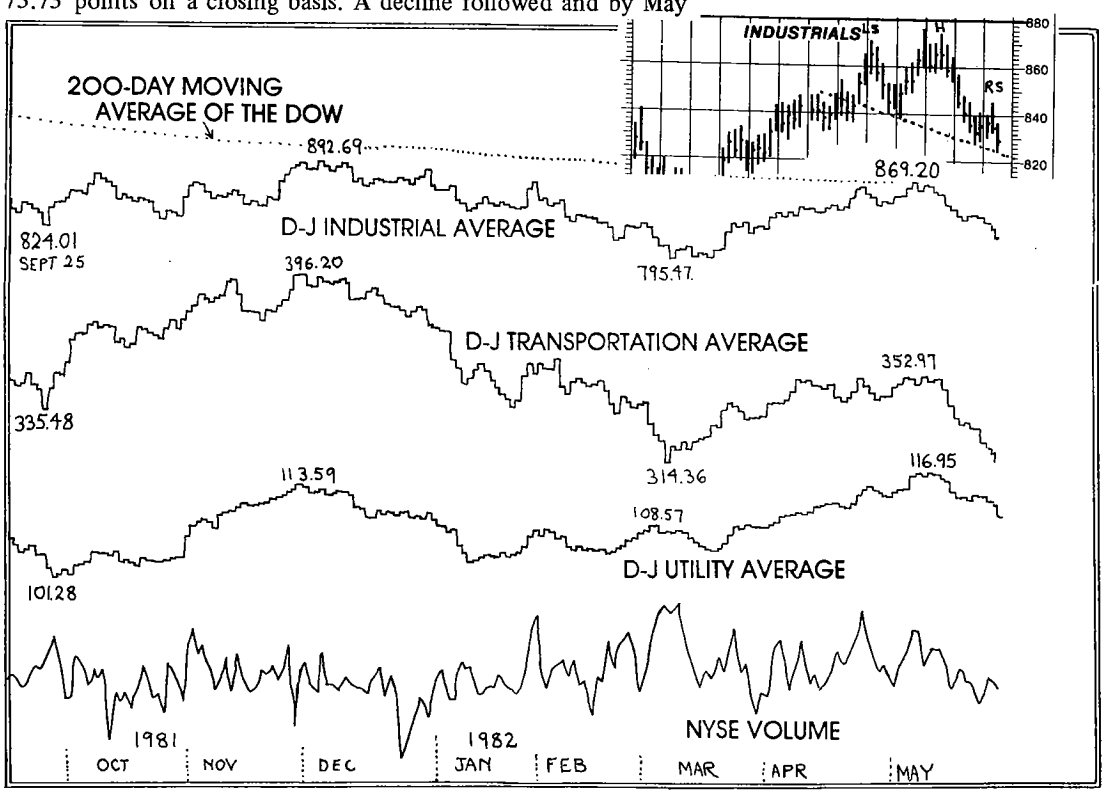
Meanwhile, Congress carries on a cowardly game of political football with the Federal budget. The situation is so bad, so far from reality, that the best Congress can hope for is a 1983 deficit "below $100 billion." In my opinion, the below-100 billion deficit is a paper dream calculated to comfort the electorate. Small comfort, indeed.

As far as the stock market is concerned, the page 1 chart of the Averages tells the story. Between March 8 (Dow 795.47) and May 7 (Dow 869.20) the D-J Industrial Average rallied 73.73 points on a closing basis. A decline followed and by May 26 the Dow was down to 828.77. In so doing, the Dow gave back MORE than 50% of its March-to-May gains, never a good sign (strong markets tend to hold at least half their gains).

FRONT PAGE COMMENT: Congress's refusal to come to grips with the Social Security issue is an omen. It tells me that where politics are concerned, the issue of solvency will be put aside. The fact is that the proposed $40 billion cut in Social Security is too hot for either the Republicans or the Democrats to handle. Thus, the decision has been made by both parties to "take the Social Security cuts out of the 1982 budget discussions."

The big argument remains: Democrats basically want to raise taxes and keep spending. Republicans want to cut taxes and shave spending increases. President Reagan feels that if his tax cuts are erased, his whole supply-side program goes up in smoke. After all, without the tax cuts, what's left of the Reagan platform—except huge deficits?

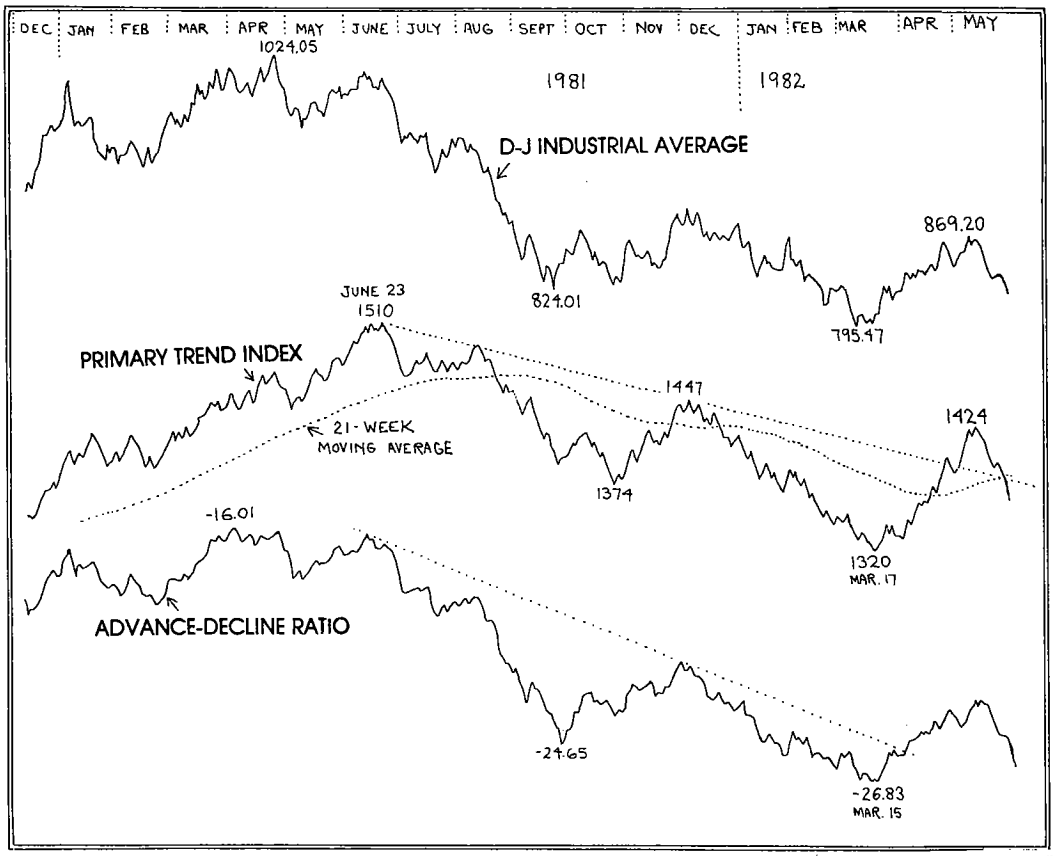
The upshot could be, it just could be, that there will be no budget at all prior to the October 1, 1982 fiscal year. So far, the 1983 budget situation remains a carbon-copy of the past—apologize to the American people for this year's deficit, and promise that you'll do better next year and the year after.



Furthermore, the March-May action traced out compact little head-and-shoulders patterns in all three Averages, and I have shown this in more detail via the insert of the Industrial Average (insert is from the WSJ). Any closing below 820 in Industrials would complete the head-and-shoulders top—in which case I would expect a test of the 800 level in the Dow.

The critical (primary) points for the D-J Averages are the March 8 lows—Industrials at 795.47 and Transports at 314.36. A breaking of BOTH of those lows would reconfirm the primary bear market.

I have written repeatedly about the deceptiveness of the bear, about the bear's great desire to decline with as MANY stockholders on his back as possible. To do this the bear must periodically provide hope. He has to provide food for the bulls. The best food is frequent optimistic comments from economists and Wall Street salesmen.



Such optimism, combined with sporadic bear market rallies, invariably succeeds in bringing new stockbuyers into the fold.

An increasing number of analysts believe that the market is now in the process of basing–their worst case scenario being a final test by the market of the March lows. Maybe they're right, but my own feeling is one of skepticism. There is no question in my mind (even if you are a bull) that we must give this market MORE TIME. So far, the years 1981 and 1982 have been losers for the vast majority of investors. Belief in the bear has saved us hours of agony and in many cases thousands or even millions of dollars. As of this writing, the market has produced nothing to cause me to reverse my belief in the bear. When the market offers contrary opinion, I'll be the biggest bull on the block.

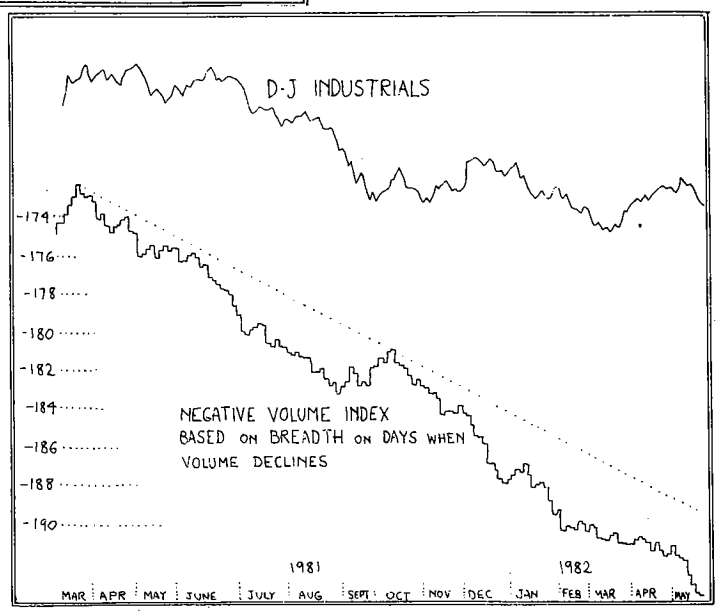
In his latest Letter (May 22) my old friend Joe Granville makes an extraordinary statement. He writes, "Until people realize that they are mixed up with the greatest bear market since 1929, they will never understand what is happening." Now I can't agree with Joe–nor can I disagree with him. I simply don't know. But I do know enough not to try to outguess a confirmed primary bear market. I can also say that I've known Joe for 21 years, and I have a lot of respect for his intuition. So let me put it this way: Joe's frightening statement represents a very contrary opinion. But I wouldn't bet my house and garden on his being wrong.

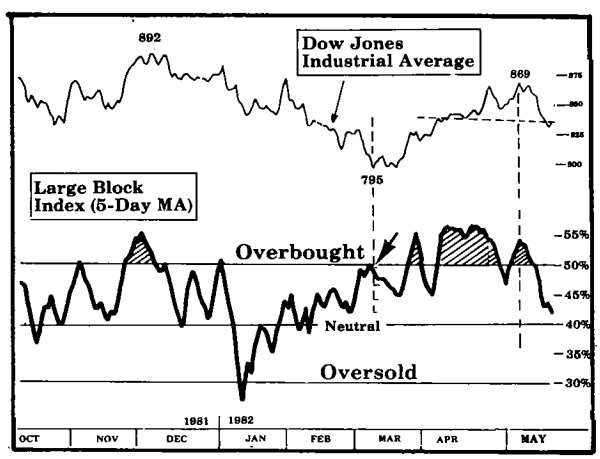
All right, now let's turn to the chart of the Primary Trend Index (PTI). This is my proprietary index, composed of eight averages and indices. Those of us who have followed the PTI over any reasonable period of time know that this instrument has been invaluable in keeping us on the right side of the market.

Note that a small head-and-shoulders pattern formed and was completed by the PTI. The declining trendline and the 21-week moving average both converge at the 1380 level. On May 26 the PTI declined to exactly 1380. On May 27 the PTI broke below the 1380 level–thus turning the secondary trend of the PTI down (the primary trend of the PTI has all along been bearish).

The advance-decline ratio (a proxy for ALL the issues on the NYSE) has put on an unimpressive performance ever since its March 15 low. The A-D rose about 3 points during the rally, and as of now it has given back over half its gains. The PTI looks stronger than the A-D ratio–but the general picture can best be described simply as "bear market rally."

NEGATIVE VOLUME: Over the years I've written a good deal about negative volume. Negative volume was the discovery of Paul Dysart of Trendway service. Dysart noticed that uninformed money tends to enter the market during days of high emotion





(rising volume days). Conversely, he noted that informed money tends to act during days of calmness (days in which volume is low). Taking this thesis a step further, Dysart divided market action into two segments, days when volume is higher than the preceding day's volume, and days when volume drops below the preceding day's volume.

Thus he divided the advance-decline figures into two areas. Positive volume shows the advance-decline figures on those days when volume is above the preceding day's volume. Negative volume shows the A-D figures ONLY on days when volume is below the preceding day's volume.

In "the old days" the uninformed money (i.e., money that acted on positive volume days) was considered to be the public, informed money was simply thought of as the sophisticated private investors. Today that concept has changed. Today the institutions rule the market. So today uninformed money is considered to be institutional or pension plan money, as for informed money, it is the same. Informed money today (as always) consists of private, sophisticated, wealthy individuals. Their action is tracked by the negative volume index.

The Page 2 chart follows the path of the negative volume index from March, 1981 to the present. As you can see, at no time since early-1981 has the market been supported by negative volume. Very simply, the conclusion here is that informed money has utilized every advance, every rally, as an opportunity to distribute stocks. Over and over again, despite minor upward blips in the negative volume index, the negative volume index has continued to tumble to lower levels.

The latest example occurred on May 18, a day when the Dow plunged over 12 points. On that day the negative volume index smashed to a new bear market low, thus continuing the dismal pattern of this index throughout 1981 and 1982.

Surveying the whole situation, we see that rising volume puts this market up, but when volume contracts the gains (which occurred under rising or positive volume) have not been sustained. In a strong (bull market) positive volume puts the market up and those gains tend to hold when volume contracts. In a bear market positive volume may put the market up, but the gains turn to losses when volume contracts. This phenomenon shows clearly in the action of the negative volume index, as seen on this chart.

Confirming this study is this chart by the excellent *Exchange Insider Reports* (PO Box 1508, Pinehurst, NC 28374). To understand the chart you must realize that the institutions are today's "public". The institutions tend to load up at the top of rallies and dump stock at the bottom of declines. Who sells to the institutions? The answer is the informed money (exchange members, astute individual investors, etc.) sells stocks to the institutions.

The lower Page 2 chart (based on up-ticks or down-ticks in big-block transactions) shows that at the lows of early-1978 and early-1980 the big block buyers were dumping blocks on down-ticks. In other words, the institutions were bearish at the lows. But during March, 1982, with the market at its 1982 low, the big-block traders were bullish. Then when the market rallied into May, the big-block index exploded to 54. Thus, institutions went from bullish (at the March bottom) to hysterically bullish (at the May top).

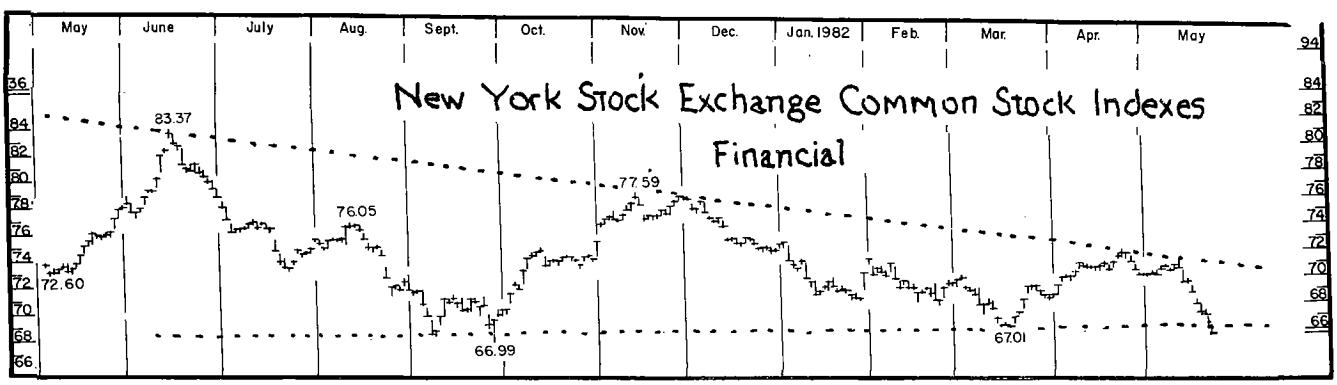
This is a far cry from the action of the institutional big-block traders during 1978 and 1980. In 1982 the institutions were consistently bullish, and only increased their bullishness as the market pushed higher into May. By fall we should see whether the big-block traders have been correct. My guess is that the uninformed institutional money will be proved wrong.

FINANCIAL WATCH: One index that is seldom watched is the NYSE Financial Index. This very broad index (bottom of page) contains almost every stock on the NYSE which pertains to finance, stocks such as the banks, savings & loans, small loan companies, etc. As such the Financial Index becomes a critical barometer of the financial health of the nation.

I've been watching the Financial Index closely of late because it's now "saying something" important. Note that the daily chart formed what is known as a descending triangle. In a descending triangle each rally terminates at a lower level and each decline terminates at roughly the same level. This is a distribution pattern, and ultimately there is a final break to new lows.

The September low in the Index was 66.99. The March low was a fraction higher at 67.01. The Financial Index, after rallying into April, 1982, turned down in late-April. During mid-May the Index plunged. By May 27, the Financial Index closed at 65.87, its lowest close in two years. And the distribution pattern shown on the chart was completed. To my mind, the new low on this broad index of financially-oriented stocks must be taken bearishly. And in case you have wondered why the Utility issues have suddenly turned weak, I would say that they have been following the Financial Index down (Utilities with their huge debt loads and interest-sensitive structures, are affected by the same forces that have driven the financial stocks down).

(Chart is courtesy of Mansfield, Journal Square, Jersey City, NJ 07306). The daily figures for the Financial Index are carried on the stock market page of the WSJ under "Other Market Indicators".



INVESTMENT POSITION: We're basically liquid, basically in 91-day T-bills. On May 26 the Commodity Research Bureau's broad index of 27 commodities (see Letter 831) broke to a new 3-year low. In case you didn't know it, that's deflationary! And it's a lead indicator. The sweet wine of inflation is dying, and the new pain of deflation is making its appearance. Inventory profits? Easy mark-ups? Real estate bail-outs? Forget 'em! Can the nation stand the pain of deflation? Does it have a choice? We'll see.

In the meantime, SAFETY of principle is the essence of intelligent money management. In due time, even the New York bank crazies (like Chase Manhattan) will learn the meaning of safety. Those who doubted me last July (at the time of the Dow Theory bear signal) are beginning to see the wisdom of capital preservation during a bear market. By year-end, even dyed-in-the-wool optimists should see what I mean.

NOTES & QUOTES: I just got off the phone with Melvyn Lippman, a very old friend and president of *US Organization Chart Service* here in La Jolla. His business is researching, collating and publishing military and industrial information. Here is what Lippman told me. The Russian military lead is pulling away from the US, and doing it rapidly. The US would have to increase its current proposed military budget 50% (that's right, 50%) in order to catch up to the Russians. Within two years Russia will have undisputed military superiority over the US.

Within two months Russia will announce three "new generation" fighter-bombers with technical capabilities comparable to the proposed B-1 bomber. But the Russian planes will not be "proposed," they will be coming off the line! Lippman says that he believes that the US is going to try to use US quality to offset Russian quantity. Says Lippman, "It won't work." Lippman is also of the opinion that the MX missile concepts are ridiculous. None of the proposed US plans for the MX, states Lippman, are of any real value.

* *

Why don't the banks foreclose on what's left of International Harvester? Well, I'll give you one reason. According to the latest Value Line figures, Harvester has pension plan liabilities of $1.1 billion. Few people realize this, but pension plan liabilities come BEFORE all other debts, including bond and notes. Thus, if Harvester goes into bankruptcy, no one can be sure how much they will receive (after pension plan payments). Furthermore, Harvester isn't the only one with huge pension plan liabilities. Going through the list (each Value Line analysis lists liabilities) is an eye-opener.

* *

The Chase Manhattan losses from the Drysdale disaster are adding up. An initial $160 million, then $110 million in interest on the Drysdale bond portfolio. In case you're wondering, that's over a quarter of billion dollars in losses for Chase. I wonder, who at Chase checked Drysdale's credit? You never see any articles about that, do you? Know why? Because the credit-checkers were probably a group of high ranking Chase officers!

THE TRIBUNE (2) San Diego, Monday, November 9, 1981

A 'vibrant, healthy' economy seen in 1982 by Reagan aide

WASHINGTON (UPI) — The Reagan administration, which says the nation has slipped into a recession, insists it has laid the foundation for an economic recovery by the middle of next year.

Citing record tax and spending cuts as well as reduced federal regulations and a sinking inflation rate, White House chief of staff James Baker voiced confidence yesterday that there will be better fiscal times in 1982.

"Admittedly we see a recession today, but the foundation has been laid to recover from that and to see an economy that is productive and that is vibrant and that is healthy by the end of next spring or the start of next summer," he said.

Baker, appearing on NBC's "Meet the Press," said President Reagan's "supply-side" economic plan has been in effect for only about 40 days and said "most people are willing to give the president time" to see if his

JAMES BAKER
'Foundation is laid'

"You'll see a number of those changes," Baker said, predicing such minor moves can mean major savings in programs like Medicaid.

Sen. Pete Domenici, R-N.M., chairman of the Senate Budget Committee, said yesterday that Reagan realizes Congress will only approve about half of his latest round of budget cuts.

He told ABC News that Reagan can only expect about $7 billion in new budget cuts for fiscal year 1982, instead of his original proposal of $13 billion.

Baker, making his points in a measured voice, said:

—"The president came into office promising the American people a tax cut, and they've received the most substantial tax cut in history.

WHO DO YOU BELIEVE? On November 8, 1981, White House Chief of Staff James Baker issued a glowing prediction about the 1982 economy. This statement came four months after the Dow Theory bear signal of July 2, 1981. When I read the Baker statement I thought, "What arrogance, what ignorance! The precious metals market has caved in, the bond market has crashed, commodities are sick, and the stock market has signalled a bear market. Yet Baker says all will be well next year. I'll just clip this article and show it to my subscribers in about six months. Let them judge whether there's more validity in the verdict of the market—or the verdict of President Reagan's chief aide."

Thursday, May 20, 1982

Corporate Profit Slump Second Worst in History

Before-Tax Figure Drops by $43 Billion in First Quarter as Economy Struggles With Recession

By DAVID TREADWELL, *Times Staff Writer*

WASHINGTON—Corporate profits suffered their second-largest drop ever in the first quarter of this year as the economy continued to stagger under the impact of the recession, the Commerce Department reported Wednesday.

From January through March, before-tax profits fell from an annual rate of $212.8 billion to a rate of $169.8 billion, and after-tax profits declined from a rate of $144 billion to a rate of $118.8 billion, the report

needed to maintain the economy at levels of prosperity sufficient to absorb new job seekers.

In releasing the new corporate profit figures, Commerce Secretary Malcolm Baldrige acknowledged in a statement that "the recession has had a strong effect on corporate earnings."

Before-tax profits were down 27.5% from the third quarter and 33.9% from the first quarter of last year, he said. During the first quar-

The second clip came out on May 20, 1982, seven months after the Baker statement. We now see that the Dow Theory's prediction was correct, and we also see that Baker could not have been more wrong.

The lesson is this: distrust all statements from politicians; distrust most statements from corporate leaders and labor leaders. Most "predictions" tend to be self-serving or the product of hopes and wishes. There is only one place from which accurate economic forecasts come—that place is the market.

Don't you think it's ironic that a Republican President who honestly believes in massive spending cuts and a balanced budget is presiding over the biggest budget deficits in history? Of course it's not Reagan's fault, the deficits have taken on a life of their own. Now the wags are starting with their sick humor. One comedian refers to "Reaga-mortis" having set in. A New Mexico outfit offers a "Survival Kit for the '80s" What is it? It's a tin cup and a generous supply of pencils.

* *

First Vietnam, then Watergate, then the 1980-82 recession, and now we learn that in a straw vote among Democrats, Teddy Kennedy won big as the "candidate for president, 1984." Can this nation survive disaster after disaster?

* *

I don't often recommend causes, but I am going to recommend that you support the National Taxpayers Union by subscribing to their publication, "Dollars & Sense." Address is 325 Pennsylvania Ave., S.E. Washington D.C. 20003. This is a worthy outfit that fights against the spendthrift government and its wild-spending Congressmen. The publication keeps you abreast of the good fight and also fills you in on the ongoing Washington horror story.

* *

If you want a picture of the future of automobiles, go take a look at the new Datsun Maxima line. We just bought a Maxima stationwagon. This beautifully finished car comes with diesel (which we picked) or standard gas engine. The Maxima wagon sells for slightly over $12,000, and has everything from air conditioning to cruise control to sophisticated radio with a scan, cassette player, etc. My wife, Paula, took the Maxima in for its 1000 mile check yesterday. Paula said she overheard a man saying, "I've had Mercedes for years, and I just bought my first Datsun Maxima. I wouldn't touch a Mercedes after owning a Maxima–and it isn't just the price!"

I guess the final clincher on the auto picture has arrived. Have you seen the new Chrysler TV ads for the Dodge Challenger? The ad boasts that the Challenger is manufactured by Mitsubishi in Japan and possesses Japanese quality workmanship. How the mighty have fallen!

* *

Most states' constitutions prohibit budget deficits. As the recession lingers on, this is causing problems. Last week's 45-state national conference (in Denver) came up with some interesting facts. Of the 45 states, 9 have made across-the-board spending cuts, 9 are planning reductions in the state work forces, and almost none are planning new spending programs. On the tax side, 5 states raised personal income taxes, 7 states increased sales taxes or maintained temporary sales levies, 5 raised corporate taxes, 3 increased severance taxes, 8 raised gasoline taxes, 5 raised taxes of alcohol and tobacco.

And as you know, state after state continues to issue municipal bonds. For the politicians, the hour of truth has not arrived yet–but it's coming, and fast.

Los Angeles Times

States Feeling Bite of Recession Raise Taxes, Cut Spending

By BILL CURRY, *Times Staff Writer*

DENVER—The nationwide recession has forced a large majority of the state legislatures meeting this year to raise taxes or cut state spending to offset dwindling revenues, according to a new survey by the National Conference of State Legislatures.

Citing widespread increases in such broad-based levies as sales and income taxes, the survey concluded "that states are coping with serious budget problems." Thirty of them, in fact, faced budget deficits prohibited by their constitutions unless legislative action is taken or the economy improves.

* *

When I lived in NYC the Hamptons (Southhampton, East Hampton) were lovely semi-deserted Long Island beach areas frequented by the rich. The Hamptons are now rather crowded, and they are the "in" spots for large groups of New Yorkers. Prices in the Hamptons are also a barometer of the upper crust of the economy. But as this squib from New York Magazine indicates, the crust is beginning to crack.

Hamptons Prices Sinking

THE HAMPTONS SUMMER-rental bubble, which last year saw one four-bedroom beach cottage command a sky-high $25,000 a month, has burst.

This year, $25,000 will snare a *five*-bedroom ocean-front house for the whole season. One realtor claimed that's "apples and oranges." Still, he admitted rents for all but the swankiest Hamptons manses are down by at least 10 percent.

According to top agent Tina Fredericks, the 1981 price boom encouraged more owners to try to lease their property.

"But between the bad weather and Reaganomics, very few lookers came, and now a lot of owners are calling me up and saying they'll take any reasonable offer," said Fredericks, who owns rental homes herself and recently leased one for a reduced price, which she won't reveal. "It's too embarrassing," she said.

* *

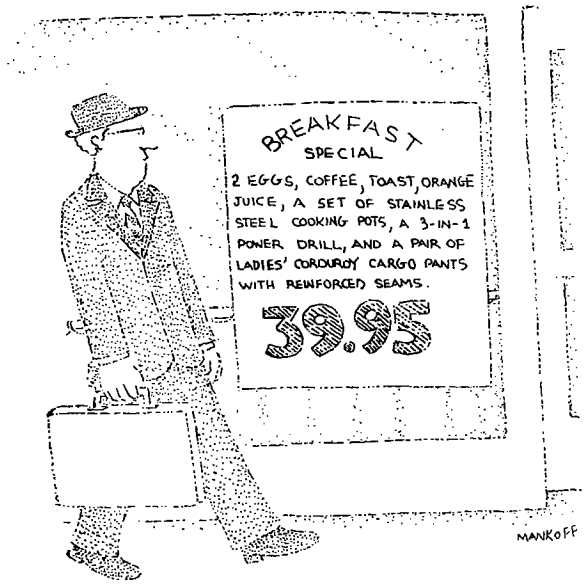
From our "Play it again Sam" Dept: Last September 30 Congress raised the US debt limit to above the trillion dollar mark. Coming up–the Reagan Administration will ask for a $195 billion boost in the debt ceiling-- to a record $1,275 trillion.

* *

After ten days of cloudy weather, the sun broke out in La Jolla today. I spent some time in my cactus garden, and everything was in bloom. Such strange-sounding names as Winteria aureispina and Mammillaria magnimamma were sending their exotic flowers out for all to see (or at least for me to see). I've finally figured it out.

Aside from the fact that they are God's creatures and they are growing, I get a feeling of peacefulness, order, when I wander through my thousands of plants. Somehow, with the world (the human part of the world) in turmoil, I find it comforting to have a place where sanity seems to reign. To me, hundreds of plants growing, blooming, multiplying, serve to demonstrate that there is beauty, intelligence, health in the world. The devil

with the news reports, to hell with the evening paper, I'll just spend another hour in my Cactus garden. I guess each man has to find his "sane corner" of the planet, and the garden is mine.


BREAKFAST
SPECIAL
2 EGGS, COFFEE, TOAST, ORANGE JUICE, A SET OF STAINLESS STEEL COOKING POTS, A 3-IN-1 POWER DRILL, AND A PAIR OF LADIES' CORDUROY CARGO PANTS WITH REINFORCED SEAMS.
39.95
MANKOFF

Things are getting tough, and this New Yorker cartoonist may have the answer. Give 'em a breakfast special, and just add on a few items. Call it creative (or desperate) salesmanship!

SECURITY RESEARCH: 208 Newbury St., Boston, Mass 02116 has just come out with a most beautiful and instructive chart book ($59). It's 444 big pages of stock charts, each chart going back to the late 1940's. And the charts are ratio scaled. Dividends and relative strength lines are included, and the stocks are monthlies. The first 48 pages contain stock groups. In all, a must for the serious investor or student.

PERCENTAGES: One of the most difficult concepts to get across to investors is the concept of percentages. The reason bear markets, for instance, are so devastating is that once you "ride through a bear market" with your stock portfolio, the percentages are against you. Why is this? Simple. If you own a $40 stock, and that stock drops to 20, you have lost exactly 50% of your money. But in order to break even, that stock must double from 20. In other words, to get even your stock must embark on an advance of 100%.

Now the fact is that it's a lot easier for a stock to drop 50% than it is for a stock to rise 100%. And that's the reason why the percentages can play havoc with a portfolio of stocks. And it's the reason why bear markets are so destructive.

All right, then how do you beat the percentages? There's only one way. You must avoid the ravages of bear markets. And you must be a buyer during bull markets.

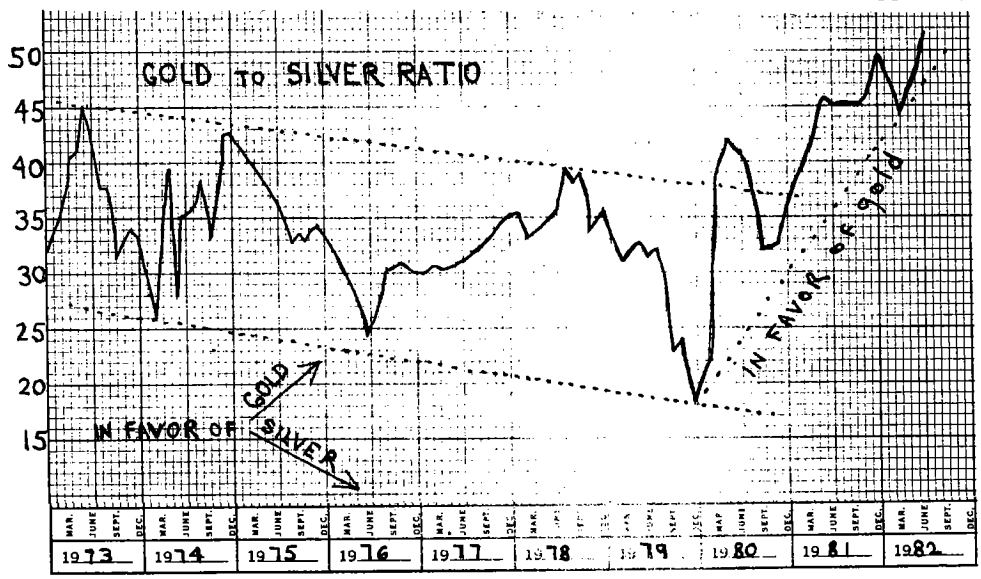
NEXT MAILING: June 11

GOLD, SILVER: About a year ago all the smart boys were recommending silver as an even better play than gold. In fact, the perfect spread was announced: buy silver and sell gold. But the best laid plans. . . . As you can see on this chart, the ratio of gold to silver has been exploding–in favor of gold over silver (ratio is gold divided by silver).

Why? What's happening to silver. Well for one thing (as I've so often stated) silver is an industrial metal, a semi-precious metal to be sure. But gold is money, and silver is not. Gold is held by the major central banks, silver is not. Gold is the survival metal, silver is not.

But there is one other cloud on the horizon for silver. And that's photography. The biggest use for silver is in photography. But the Japanese have now come out with an electronic camera that takes pictures that you flash on your TV screen. No silver is involved. Also, home TV cameras are (in my opinion) going to run 8mm cameras out of town. There is simply no comparison in home use of a color TV outfit as compared with film. So I see the long-term future of photography as a move to less or even no silver.

So much for silver. As for gold, the moving averages pretty much tell the story. The 50-week or primary line for gold now stands at 395 (roughly 70 points above the price of the actual metal). The 13-week or intermediate term MA for gold stands at 344. The 5-week MA is at 335. Thus, the three MA's are still in the bearish syndrome. The first bullish indication for gold would be a rise in the spot price above 335 (and the metal should HOLD above the 335 level. So far, that hasn't happened.)



LATE NOTES: I consider last week's actions quite significant. The PTI broke down rather dramatically. And the averages were very weak. The Transports are now so out of line on the downside that I would guess that in the event of a new rally, we can expect a non-confirmation on the part of the carriers. The Utility Average (which had begun to look promising) broke down badly, thereby shattering the hopes of those who use the Utility Averages as a "lead indicator."

On top of this, I consider the new lows on the part of both the CRB Commodity Index and the NYSE Financial Index to be definitely bearish. The weakness in commodities in the face of the sharply rising M-1 money component and the May 28 rise in the "leading indicators" underscores the power of the continuing Deflationary pressures.